



RENEWABLE ENERGY UPDATE

IRS ISSUES LONG-AWAITED GUIDANCE ON CO-FIRING OPEN-LOOP BIOMASS

On September 26, 2006, the IRS issued Notice 2006-88 (the "Notice") to address a number of unsettled questions relating to the application of the Section 45 production tax credit to open-loop biomass facilities. The Notice provides important guidance almost two years after Congress expanded the section 45 production tax credit to open-loop biomass facilities and more than a year after the IRS surprised the industry by refusing to issue private letter rulings under new section 45.

In this update, Curt Whittaker, Paul Burkett and Bill Ardinger summarize the Notice and examine its potential impacts on open-loop biomass projects.

Executive Summary

The Notice provides much needed guidance for owners and operators of open-loop biomass facilities:

- Most importantly, the IRS has agreed that the section 45 production tax credit is allowed for electricity attributable to the use of qualifying open-loop biomass fuel *even if the qualifying open-loop biomass is co-fired with other non-fossil fuels* (subject to the general limits in section 45 and some new limits the IRS seeks to impose under the Notice).
- For an open-loop biomass facility, the amount of electricity produced and sold that is eligible for the credit is the *net electric output* (gross electric output less station load).
- The IRS has provided a working definition of "open-loop biomass facility" and announced its intention to follow the so-called "80/20 rule" for purposes of determining when an open-loop biomass facility is placed in service.

- The IRS has announced two new "no-rule" positions under section 45:

- (1) The IRS will not issue any private letter rulings under section 45 with respect to open-loop biomass; and
- (2) The IRS will not issue any private letter rulings under the partnership rules for partnerships claiming the section 45 credit.

We address each of these issues in more detail below.

The Rath, Young and Pignatelli Tax and Energy Practice Groups represent clients seeking to develop, operate and invest in energy projects that qualify for federal tax benefits. For more information on our practice, please contact:

- Curt Whittaker (mcw@rathlaw.com)
- Paul Burkett (pab@rathlaw.com)
- Bill Ardinger (wfa@rathlaw.com)

You may call us at (603) 226-2600 or visit our website at www.rathlaw.com.



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Pro-Rated Credit for Co-Fired Fuel

The IRS spent more than a year puzzling over how to treat open-loop biomass plants that co-fired qualifying open-loop biomass with other non-qualifying fossil and non-fossil fuels. After receiving a number of written submissions from taxpayers and holding several conferences with taxpayers and their advisers, the IRS ultimately reached a common-sense conclusion that provides both certainty and fairness to the industry.

Co-Firing Defined. The IRS has taken an expansive view of what constitutes “co-firing” to include (1) commingling fuels during combustion, (2) commingling steam produced separately from the combustion of two or more fuels, where the steam is commingled before or during the production of electricity, and (3) commingling electricity produced separately from two or more fuels. The commingling of electricity produced from different sources had previously been addressed by the IRS in a 2005 private letter ruling, but the commingling of fuel or steam prior to or during the production of electricity were new concepts introduced in this Notice.

No Minimum Amount of Qualifying Fuel Required. The IRS took a reasoned position that, except with respect to open-loop biomass co-fired with fossil fuel in amounts greater than required for start-up and flame stabilization (see below), any electricity sold that is attributable to qualifying open-loop biomass is eligible for the section 45 credit. Thus, if for economic or other reasons, a plant burns 95% tire-derived fuel or other non-qualifying, non-fossil fuel and 5% qualifying wood chips for

a period of time, 5% of the electricity produced and sold during this period is eligible for the section 45 production tax credit.

Other Fuels May Also Claim Credits. As an extension of the basic co-firing rule established for qualifying open-loop biomass, the IRS also announced that, if a fuel co-fired with open-loop biomass is itself a “qualified energy resource” under section 45 *and* if the facility in which the fuel is burned meets the placement-in-service date requirement for that fuel type, then the electricity sold that is attributable to the other fuel will also be eligible for the section 45 production tax credit.

Pro-Ration of Credit Based on Thermal Content of Fuels. When two or more fuels are co-fired to produce electricity, the “applicable percentage” of the electricity that is sold to third parties is eligible for the credit. The “applicable percentage” is the percentage of the thermal content of all fuels used to produce the electricity that is thermal content from qualifying open-loop biomass or other qualified energy resources.

For example, assume a facility that was placed in service after October 22, 2004 (the earliest placement in service date for open-loop biomass facilities other than wood-burning facilities) burns, on a thermal content basis, 80% qualifying wood chips, 15% non-fossil, non-qualifying fuel such as tire-derived fuel, and 5% agricultural livestock waste nutrients. This facility will be eligible to claim the section 45 production tax credit with respect to 85% of the electricity produced at the facility that is sold to third parties, representing the 80%



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share of thermal input from wood and 5% from agricultural livestock waste nutrients.

Co-Firing with Fossil Fuel. Under section 45, “open-loop biomass” does not include biomass co-fired with fossil fuel *in excess of the minimum amount of fossil fuel necessary for start-up and flame stabilization*. If open-loop biomass is co-fired with fossil fuel, then (1) the amount of fossil fuel (unlike other types of fuel) must be limited only to the amount necessary for start-up and flame stabilization, and (2) only the electricity produced and sold that is attributable to open-loop biomass is eligible for the section 45 production tax credit.

The Notice does not provide any guidance on the meaning of “start-up and flame stabilization.” However, these are concepts familiar to owners and operators of open-loop biomass facilities under FERC’s regulations implementing PURPA, and we believe that the IRS would look to these regulations for guidance.

Credit Reduction for Electricity Purchased and Used at an Open-Loop Biomass Plant

Section 45 requires that the electricity produced using a renewable energy resource must be sold to a third party to generate the credit. This statutory rule clearly excludes from the credit electricity produced at a facility that is used to serve station load at the facility, because station load energy is not sold to a third-party. That is, a generation facility serving its own load realizes the section 45 credit only for its net electric output.

The IRS sought to maintain that result in circumstances where a generation facility sells all of its gross electric output and buys its station load from the local grid. However, it went further to include not only station load, but also the load of any integrated paper mill or other industrial complex in the calculation of the net output eligible for section 45 Credits. Thus, “[i]f electricity produced from open-loop biomass at any *location* is sold by a taxpayer to an unrelated person and either the taxpayer or a related person simultaneously purchases electricity from an unrelated person for use at the same *location*, the sale of the electricity will be treated as a sale to an unrelated person only to the extent the amount of electricity sold exceeds the amount of electricity purchased.” [emphasis added]

For example, if a qualified open-loop biomass facility integrated with a paper mill produces and sells to a local public utility 1000 kWh per day and simultaneously the entire mill complex (including the power plant) purchases 800 kWh per day from the utility to operate the facility and the paper mill, then only 200 kWh of the electricity sold will be treated as sold to an unrelated party.

Based on this guidance, owners of paper mills may seek ways to capture the value of the tax credits by leasing the power plant to an unrelated party or engaging an operator to be the “producer” of the electricity for purposes of section 45.

Definition of “Facility”

The section 45 statute does not define the key concept of “facility.” In a Revenue



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Ruling issued in 1994 (Rev. Rul. 94-31), the IRS provided some guidance on this question in the context of a wind facility. In the Notice, the IRS has built on Rev. Rul. 94-31 and provided some welcome guidance on the definition of “facility” under section 45 with respect to open-loop biomass projects.

What is Included. The general rule is that a section 45 “facility” consists of all components necessary for the production of electricity. Specifically, “a qualified open-loop biomass facility includes all burners and boilers (whether or not burning open-loop biomass), any handling and delivery equipment that supplies fuel directly to and is integrated with such burners and boilers, steam headers, turbines, generators, and all other depreciable property necessary to the production of electricity.”

What is Not Included. The following items are not part of a section 45 open-loop biomass facility: (1) equipment for collecting, processing or storing open-loop biomass before its use in the production of electricity; (2) transformers and other equipment used in the transmission of electricity after its production; and (3) ancillary site improvements, such as roadways and fencing, that are not required for the production of electricity.

Placement in Service Date

In Rev. Rul. 94-31, the IRS applied the so-called “80/20 rule” to wind facilities under section 45. In the Notice, the IRS has now applied this same rule to open-loop biomass facilities under section 45.

Under the 80/20 rule, an open-loop biomass facility does not “re-vest” under section 45

and obtain a new placement in service date if more than 20% of the facility’s total value (the cost of the new property plus the value of the used property) is attributable to property previously placed in service. Because the amount of the credit and the credit period may both be affected by a facility’s placement in service date, this can become an important issue in any refurbishment or upgrading of a facility.

Other Issues Addressed in the Notice

Cogeneration Facilities are Eligible for the Credit. In the Notice, the IRS has announced that a facility using open-loop biomass to produce both electricity and useful thermal energy, such as heat or steam, through cogeneration may be a qualified open-loop biomass facility under section 45.

Wood Bark and Lignin are Biomass. Section 45 defines “open-loop biomass” to include “any solid, nonhazardous, cellulosic waste material or any lignin material which is segregated from other waste materials and which is derived from ... any of the following forest-related resources: mill and harvesting residues, precommercial thinnings, slash and brush.” In the Notice, the IRS has announced that wood bark and lignin material recovered from spent pulping liquors fall under this definition.

Effective Date and Future Guidance

Effective Date. The Notice will be effective on the date it is published in the Internal Revenue Bulletin, presumably October 10, 2006. The Notice is considered interim guidance issued pending a formal



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rulemaking project. Taxpayers may rely on the Notice until regulations are issued.

Regulations to Come. The IRS and the Treasury Department will undertake a formal rulemaking project regarding the section 45 production tax credit as applied to open-loop biomass facilities. As part of this rulemaking process, taxpayers will have an opportunity to comment on any proposals by the IRS and the Treasury Department.

The IRS and the Treasury Department expect that the regulations will include the guidance set forth in the Notice and will be effective for electricity produced after the date that the Notice is published in the Internal Revenue Bulletin. It is likely that

the publication date will be October 10, 2006.

No Private Letter Rulings. The IRS has announced that it will not issue any private letter rulings regarding open-loop biomass facilities under section 45. Thus, the Notice is the extent of published guidance that will be available for open-loop biomass until the IRS and the Treasury Department issue regulations.

Separately, the IRS announced that it will not issue any private letter rulings for any facility types under section 45 with respect to any partnership issues. This position may reflect growing unease at the IRS with some of the partnership structures being used by taxpayers to monetize the section 45 production tax credits.